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No. 171

IN THE

Supreme Court of the United States

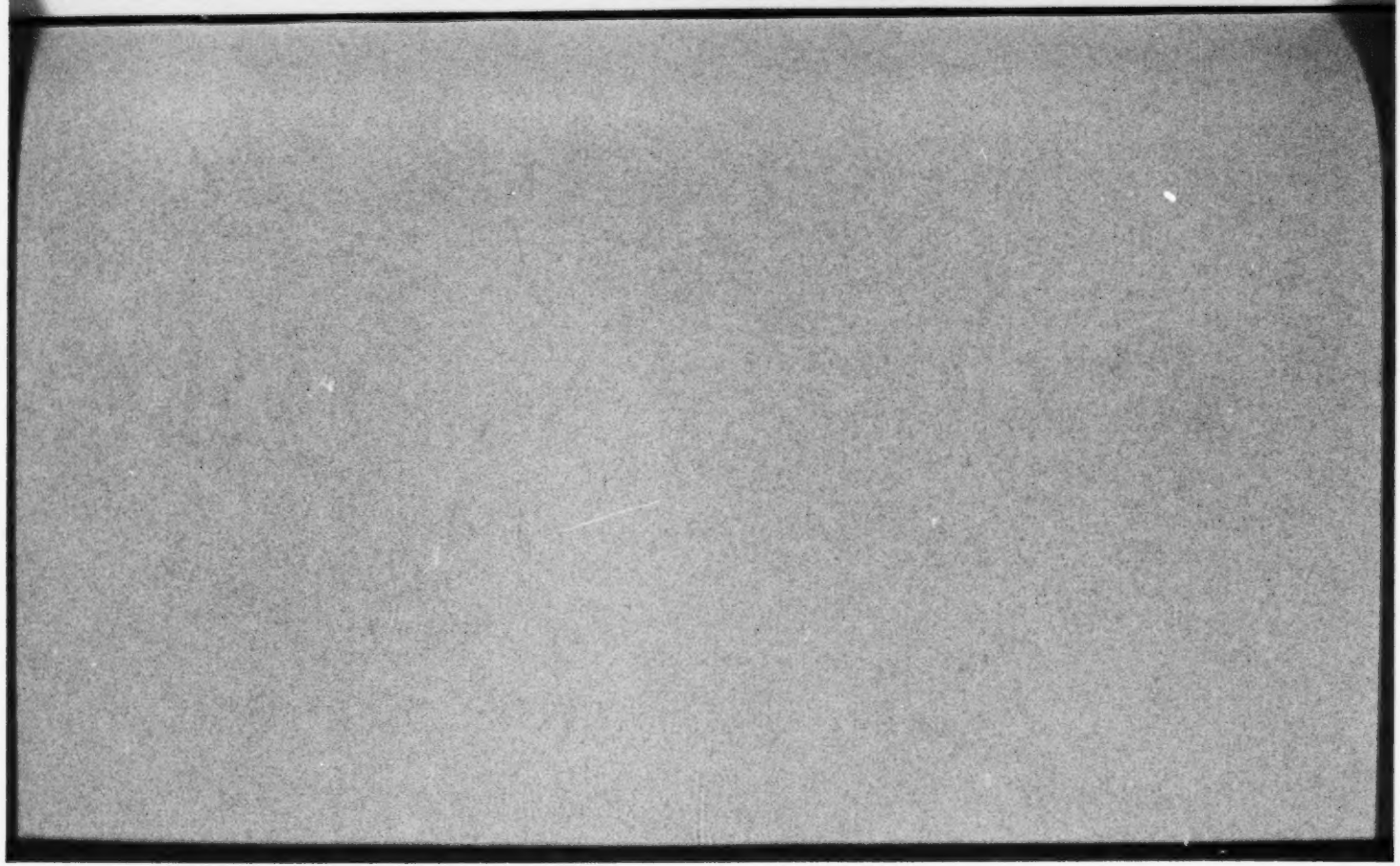
OCTOBER TERM 1941

THE HADEN COMPANY, *Petitioner,*
v.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND SUPPORTING BRIEF

HOMER L. BRUCE,
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Of Counsel.



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Supreme Court of the United States

OCTOBER TERM 1941

THE HADEN COMPANY, *Petitioner,*
v.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

May It Please the Court:

The petitioner, The Haden Company, respectfully prays for a writ of *certiorari* to the United States Circuit Court of Appeals for the Fifth Circuit at New Orleans, Louisiana, to hear this cause and to review the decision of the Circuit Court of Appeals in affirming the decision of the Board of Tax Appeals. Petitioner respectfully shows to this Honorable Court:

1.

Summary Statement of the Matter Involved.

Petitioner and W. D. Haden Company (herein referred to briefly as W. D. H. Co.), were owned by the same four individuals in substantially the same

proportions. In 1935 W. D. H. Co. on its own initiative and for no consideration cancelled certain indebtedness owing to it by petitioner. The Commissioner held the cancellation resulted in taxable income and the Board of Tax Appeals and Circuit Court of Appeals affirmed his action. As a result petitioner has been assessed $21,135.98 income and excess profits taxes for that year. The sole question is whether this gratuitous forgiveness of indebtedness without any consideration was income.

The financial facts involved were either admitted or covered by stipulation. W. A. Wansley, the Vice-President and General Manager of both companies, was the only witness (R. 30), and his testimony was uncontradicted.

Both companies were at all times under common stock ownership, Captain W. D. Haden being the controlling interest and the stock being allocated among the parties by him. (R. 36.) The stock was owned as follows, being substantially in the same proportions in each company, (R. 4):

	Petitioner Shares	W. D. H. Co. Shares
W. D. Haden	180	4,100
W. A. Wansley	40	300
E. D. Haden	40	300
C. R. Haden	40	300
	300	5,000

W. D. H. Co. had its headquarters in Galveston, Texas, and was engaged in producing and selling sand, gravel and shell. In 1924, when Houston was grow-

ing rapidly, it opened retail yards in that city. However, for it to obtain the greatest outlet for these three commodities, it was imperative for it to handle many other kinds of building materials, such as brick, tile, cement, plaster materials, metal lath, etc. Accordingly, in 1929 the stockholders of W. D. H. Co. bought the stock of a general building material company, the Willingham-Ellington Company, and changed its name to The Haden Company, the petitioner. (R. 30-31.)

Petitioner was buying large amounts of materials, not only from W. D. H. Co. but from many other manufacturers, and, as it had only $30,000 capital, W. D. H. Co. had to guarantee all of its bills. Shortly after petitioner was thus acquired in 1929, the depression came and petitioner lost many accounts that were owing to it. Petitioner was also renting the property from W. D. H. Co. In order that the petitioner might pay other suppliers from whom it was buying materials, W. D. H. Co. had to defer collection of its accounts for materials and rent. As a result, at the end of 1935 petitioner owed W. D. H. Co. the following (R. 5, 29, 35):

Loans	$151,665.36
Account of materials purchased and rent on property	132,933.69
	$284,599.05
Current accounts for materials bought in 1935	11,374.11
Total	$295,973.16

On December 31, 1935, W. D. H. Co. on its own initiative and without any consideration moving to it whatsoever decided to cancel, and did cancel, the indebtedness owing to it by petitioner except the $11,374.11 owing for current materials bought in 1935. Of the $284,599.05 indebtedness that was cancelled, $132,933.69 was for materials bought by petitioner from W. D. H. Co. and rent. The Commissioner held that the petitioner thereby received taxable income of $132,933.69. (R. 7-11.) After this cancellation the statement of petitioner showed that it had net assets in excess of liabilities of $116,906.54 and the Board held that it received taxable income to that extent. (R. 16-17.) Additional income and excess profits taxes totaling $21,135.98 were assessed against petitioner. (R. 22.)

Wansley's testimony as to the circumstances under which the cancellation was made is uncontradicted. (R. 30-37.) In substance he testified: During 1935 and prior years W. D. H. Co. had to borrow large amounts of money to carry on its business and had to keep its bank supplied with financial statements several times a year. (R. 33.) The statement of W. D. H. Co. as of September 30, 1935 (R. 38-39), showed that it owed its bank as a current liability $380,000. Although it showed a large capital stock and surplus, nevertheless it had current assets of only $85,000 and among its other assets were over $386,000 of accounts receivable from other affiliated companies, of which over $295,000 was owing to it by petitioner. This showed a very unsatisfactory financial condition from

the point of view of the bank which had loaned W. D. H. Co. $380,000 on current notes. Wansley testified that the bank had questioned this indebtedness owing by petitioner several times and had stated that it did not seem to mean anything and did not look so well on the Company's statement. (R. 33.) He then testified that the board of directors of W. D. H. Co. in December, 1935, on their own initiative decided to cancel this indebtedness of petitioner and did do so. (R. 33-34.) He testified that, as W. D. H. Co. was the responsible company, all decisions were made by that company and that the directors in cancelling the indebtedness acted as the directors of W. D. H. Co. (R. 36-37.)

The Board of Tax Appeals (R. 14-18), simply held that the cancellation amounted to income to the extent that petitioner had net assets after the cancellation on the ground that (simply quoting from the decision of this Court in the *Kirby Lumber Company* case)[1], petitioner "realized within the year an accession to income." The Circuit Court of Appeals affirmed the decision of the Board, using substantially its same language to the effect that the petitioner thereby "realized within the year an accession to income." (R. 44, 47.)

The decision of the Circuit Court of Appeals was handed down on March 19, 1941. (R. 44.) In due time the petitioner filed its motion for rehearing on April 17, 1941 (R. 49), which motion was overruled on May 10, 1941. (R. 60.)

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[1]*United States v. Kirby Lumber Co.*, 284 U. S. 1.

2.

Statement Disclosing Basis Upon Which This Court Has Jurisdiction.

Jurisdiction of this cause is conferred upon this Honorable Court by Judicial Code, Section 240, as amended; United States Code, Title 28, Section 347.

3.

Question Presented.

Did petitioner on December 31, 1935, become liable to the United States for $21,135.98 income and excess profits taxes merely because W. D. H. Co., without any solicitation therefor on the part of the petitioner, gratuitously, on its own motion and for no consideration cancelled this indebtedness? Could W. D. H. Co. as the creditor of petitioner thus on its own initiative create a liability on the part of petitioner to the United States for this $21,135.98?

4.

Reasons Relied on for the Allowance of the Writ.

The reasons relied on for the allowance of the writ are that the Circuit Court of Appeals has decided important questions of Federal law which have not been and should be settled by this Court, and that these questions have been decided in a way probably in conflict with the applicable decisions of this Court and with decisions of the other Circuit Courts of Appeals.

(1) The Circuit Court of Appeals held that by the cancellation the petitioner "realized within the

year an accession to income." As any benefit that petitioner received from the cancellation was wholly without solicitation or effort on its part and was not a gain derived from capital or from labor or from both combined, the holding of the Circuit Court of Appeals is in conflict with the decisions of this Court delineating what is and what is not taxable income.[2]

(2) As the cancellation was made by W. D. H. Co. on its own initiative and without any consideration from petitioner, the holding of the Circuit Court of Appeals is in conflict with the decisions of this Court and of the Circuit Courts of Appeals to the effect that payments or the transfer of property voluntarily and without any consideration are not taxable income.[3]

(3) This Honorable Court has not definitely passed upon the question as to when the cancellation of an indebtedness is taxable income and there is such uncertainty among the lower Federal courts

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[2] *Eisner v. Macomber*, 252 U. S. 189, 207; *United States v. Safety Car Heating & Lighting Co.*, 297 U. S. 89, 99; and many others.

[3] *Bogardus v. Com.*, 302 U. S. 34; *Blair v. Rosseter*, 33 F. (2d) 286; *Edwards v. Cuba Railroad Co.*, 268 U. S. 628; *Rice, Barton & Fales, Inc., v. Com.*, 41 F. (2d) 339; *Great Northern Railroad Co. v. Com.*, 40 F. (2d) 372; *Midland Valley Railroad Co. v. Com.*, 57 F. (2d) 1042; *Tampa Electric Co. v. Com.*, 12 B. T. A. 1002; *Aransas Compress Co. v. Com.*, 8 B. T. A. 155; *Cf. American Cigar Co. v. Com.*, 66 F. (2d) 425 and *W. F. Young, Inc., v. Com.* (First Circuit Court of Appeals, decided May 23, 1941, not yet officially reported), in which the court held that, where a parent corporation made loans to a subsidiary corporation when, on account of financial condition of the subsidiary, there was no expectancy that the loans would be repaid, the parent could not deduct the advance as a loss or bad debt but same was a gift.

upon the point that this Honorable Court should in this case affirmatively pass upon and settle this question.[4]

Wherefore, your petitioner respectfully prays that

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[4]The confusion over the question of whether a cancellation of indebtedness amounts to taxable income, capital contributions or a gift is forcefully pointed out in 40 *Columbia Law Review*, 1326, where it is stated:

> "The significance of the taxable effects of cancellations of indebtedness has been considerably accentuated by the excess profits tax provisions of the Second Revenue Act of 1940. Previous to this Act, confusion existed at almost every turn as to whether cancellations of indebtedness resulted in income, a contribution to capital or a gift. Judicial decisions in this field afforded little comfort to debtors or creditors who were personally concerned with the problem. Congress, in its efforts to provide a partial solution to the vexatious questions, created many further problems, some of which were even more serious and perplexing. Thus, developments in the courts and the legislature have added confusion and chaos in a field of law which for many years has been in need of clarification.
>
> "Whether a corporation bases its excess profits credit on average income or on invested capital under the excess profits tax, the taxable effect of present, past and future cancellations of indebtedness are of utmost importance. The effect of such cancellations on earnings and profits is equally significant. The meaning of the term 'contributions to capital,' as used in the excess profits tax, must be developed and clarified by the courts. In so doing, some light may be cast on the chaotically developed field of the tax consequences of cancellation of indebtedness.
>
> "Most of the judicial problems arising in this field are traceable to the landmark opinion of the Supreme Court in United States v. Kirby Lumber Company, decided in 1931. The Court there held that the discharge of bonds by payment of less than the face amount of the obligation resulted in taxable income. Since the Kirby case, the evolution of legal doctrines in this field has been inextricably interwoven with economic results. The generally lower market price of securities resulting from the depression has made this problem significant to almost every debtor. Always threatening every debt adjustment were the uncertainties as to the application of the Kirby case."

a writ of *certiorari* may issue out of and under the seal of this Honorable Court directed to the United States Circuit Court of Appeals for the Fifth Circuit commanding said court to certify and send to this Court on a day certain, to be therein designated, a full and complete transcript of the record of all the proceedings in the Circuit Court of Appeals in said cause entitled the *Haden Company, Petitioner, v. Commissioner of Internal Revenue, Respondent,* No. 9536 on its docket, to the end that said cause may be reviewed and determined by this Court as provided by Section 240 of the Judicial Code, as amended, and that your petitioner may have such other and further relief or remedy in the premises as this Court may deem appropriate and in conformity with said provision of the Judicial Code, and that on hearing before this Honorable Court said judgment of the Circuit Court of Appeals and the decision of the Board of Tax Appeals be reversed by this Honorable Court and it be held that petitioner is not liable for any deficiencies of income taxes or excess profits taxes for said year, and such relief granted as is appropriate to the cause.

THE HADEN COMPANY,
By HOMER L. BRUCE,
Attorney for Petitioner.

PETITIONER'S

BRIEF

No.....

IN THE

Supreme Court of the United States

OCTOBER TERM 1941

THE HADEN COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

The Opinions of the Courts Below.

The opinion of the Board of Tax Appeals (R. 14) and its final decision (R. 22), have not been officially reported. The opinion of the Circuit Court of Appeals has not yet been reported but is found at page 44 of the record.

II.

Jurisdiction.

Stated under heading 2 of the petition.

III.

Statement of the Case.

A full statement of the case has been given under

heading 3 in the petition and in the interest of brevity is not repeated. However, we refer to the following uncontradicted testimony of W. A. Wansley, the vice-president and general manager of both companies, as to the circumstances under which the indebtedness was cancelled:

> "When the W. D. Haden Company in December, 1935, cancelled the indebtedness of some $284,599.05 owing to it by The Haden Company, that unsatisfactory debt situation had existed between The Haden Company and W. D. Haden Company for about four years, from 1930-31. I think the most of it was accumulated in 1930-31. Prior to the cancellation of this indebtedness, W. D. Haden Company carried this indebtedness that The Haden Company owed it on its financial statement as an asset.
>
> "I have a financial statement of the W. D. Haden Company during the fall of 1935, prior to the cancellation of this indebtedness and this is the statement. (Thereupon the financial statement of W. D. Haden Company of September, 1935, was offered by petitioner in evidence and admitted and a copy thereof is marked Exhibit No. 1 to this statement of evidence.)
>
> "During 1935 and prior years, W. D. Haden Company had to borrow large amounts of money to carry on its business. It had to keep the bank supplied with a financial statement of its condition two or three times a year, perhaps; whenever they asked for it. As to the effect on its financial statement and of its position in borrowing from the banks where it showed these intercompany accounts and the amount owing by The Haden Company to it in the sum of $284,000, it had been carrying that item so long on that

statement, and the banks had questioned it several times before, that it did not seem to mean anything, that we could not recover or were not collecting, and it did not look so well on the statement, and we ourselves as directors and officers of W. D. Haden Company thought it should be removed from our statement because it was misleading and did not represent an item that we could recover. As to what the directors did in 1935 about this item of indebtedness owing to it by The Haden Company, along the first of the—early part of December in 1935, Mr. Lund prepared that statement. Our books are usually about four or five or six days behind to prepare a complete financial statement. He prepared that statement of the business on December 30 with a certain recommendation by the Board of Directors early in December for us to take some action on this Haden Company account. The Board of Directors had a meeting along about somewhere the middle of December to discuss several things that usually come before us before the Christmas holidays. Among the things discussed would be bonuses to employees for the year to be paid as Christmas bonuses, and this matter was discussed after reading a recommendation made by Mr. Lund to do that we cancelled this indebtedness, W. D. Haden Company, and cleared up our statements, because it was an item that we had no chance of collecting, and the directors at that time unanimously agreed that it be done. That was along the middle of the month. Instructions were given to our bookkeepers to cancel that indebtedness off in December, so that our January 1st statement would not carry it." (R. 32-34.)

* * * * *

"As to whether, in order to enable The Haden

Company to purchase from other concerns and have a good financial statement, W. D. Haden Company felt it was necessary to cancel this indebtedness, that was not the entire reason because we had an arrangement. The arrangement we had had been in effect for three or four years, whereby W. D. Haden Company was guaranteeing the bills anyway, and advancing them money whenever they needed it to pay the bills, but the item we couldn't collect, carried on the books of W. D. Haden Company, had reached the point that it was misleading on W. D. Haden Company's statement, and the bankers called the W. D. Haden Company's attention to it and thought it ought to do something about it." (R. 35-36.)

* * * * *

"Of course, anything important would be submitted to us, the Galveston office, before any action was taken, and had to be approved by the Galveston office of W. D. Haden Company before any action was taken. The directors and officials of the two companies were identical.

"As to whether when I say 'approved by W. D. Haden Company' I mean it had to be approved by the same directors, well, W. D. Haden Company had to approve what they did before they did that. Of course, there were the same directors. As to whether we couldn't distinguish when we were acting for one corporation or the other, well, W. D. Haden Company was a responsible company. We were responsible for everything they did, and we acted as the W. D. Haden Company in telling them what to do." (R. 36-37.)

IV.

The Law.

The applicable provisions of the statutes are set out in Appendix A.

V.

Specifications of Errors.

1. The Circuit Court of Appeals erred in the holding that by the cancellation of the indebtedness by W. D. Haden Company petitioner received taxable income to the extent of $116,906.54 and thereby became liable for additional income and excess profits taxes amounting to $21,135.98.

2. The Circuit Court of Appeals erred in affirming the decision of the Board of Tax Appeals because petitioner did not receive any taxable income on account of the cancellation of the indebtedness by W. D. Haden Company and therefore was not liable for any part of the deficiency in income and excess profits taxes proposed by the Commissioner to be assessed against it.

VI.

Summary of Argument.

As W. D. H. Co. cancelled the indebtedness on its own initiative and for no consideration, it was in the nature of a gift and not taxable income to petitioner, regardless of the motives of W. D. H. Co., whether philanthropic or business. It does not fall within that class of transactions that result in taxable in-

come as repeatedly defined by this court. Both the courts and the Treasury Department through its regulations and rulings have consistently held that transfers of property without consideration are gifts and not income.

Argument.

Both the Board of Tax Appeals and the Circuit Court of Appeals decided this case, using identical language, simply on the flat statement that petitioner realized taxable income, relying on the decision of this Court in the *Kirby Lumber Company* case[1], saying:

> "Assets to the extent of $116,906.54, previously offset by liabilities, were freed from the claim of creditors and petitioner thereby 'realized within the year an accession to income', U. S. v. Kirby Lumber Co., supra."

The Board in addition stated that the rule applicable was that, where an insolvent debtor satisfies its debts with a portion of its assets and retains a portion freed from liabilities, the debtor realizes a gain to the extent of the assets freed from the claims of creditors. The Board further attempted to base its holding on the fact that W. D. H. Co. would derive business benefits from the continuation of petitioner in business without further financial assistance from W. D. H. Co. and that it was no doubt because of these facts that W. D. H. Co. cancelled the indebted-

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[1]U. S. v. Kirby Lumber Co., 284 U. S. 1.

ness and therefore did not intend it to be a gift.

Both the Board and the lower court, we respectfully submit, wholly ignored the difference between a voluntary gift without consideration and taxable income. A mere statement that the petitioner received an accession to income merely begs the question. However, that expression that the taxpayer "realized within the year an accession to income" in the *Kirby Lumber Company* case, *supra,* has become widely quoted by the Board and Federal courts with the apparent thought on their part that, if a taxpayer in any way has received an accession to *net worth,* he has thereby realized an accession to *income.* We venture to suggest that this terse statement by this Court in the *Kirby Lumber Company* case was never intended by it to be a rule of such wide and general application as has been given to it by the lower Federal courts, and as was done by the Board and the lower court in this case. A taxpayer may have his *net worth* materially increased by a gift or by a voluntary cancellation of indebtedness by a creditor, but in neither such case has he had an accession to *income* although his assets thereafter may exceed considerably his liabilities. For example, if W. D. H. Co. had simply given petitioner a check for $116,906.54 as a contribution and petitioner had in turn used that money to pay its indebtedness in that amount to W. D. H. Co., we do not believe that the Commissioner would have even contended that the petitioner received income equal to the amount of the check. That is exactly what happened in this case. W. D. H. Co.,

instead of giving petitioner this amount in cash, simply of its own volition and without any consideration cancelled the indebtedness. Whatever the business motives of W. D. H. Co. might have been, whether it thought in the long run it would gain by the transaction or not, nevertheless the crux of the matter is whether W. D. H. Co. cancelled the indebtedness for no consideration or whether it received a valuable consideration of any kind in return. The record is uncontradicted that W. D. H. Co. received no consideration whatsoever, and whether it was actuated by business motives or the hope of future gain does not remove the transaction from constituting a purely voluntary gift on the part of W. D H. Co.

The standard definition to which the courts have had recourse in income tax cases is:

> "A gift has been defined as a voluntary transfer of property by one to another, without any consideration or compensation therefor."[2]

In the discussion by *Paul and Mertens*[3] of the essentials of a gift, the main factor is that the gift is made without any consideration moving from the donee, and the same fundamental principle is set out in all other discussions of the nature of gifts. If there is a consideration moving from the donee, then there is no gift; but if the donee does not pay any kind of consideration, then there is a gift. The motives of the donor, whether philanthropic or purely business,

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[2] *Paul and Mertens Law of Federal Income Taxation*, Vol. 1, Sec. 6.05, p. 151; *Blair v. Rosseter*, 33 F. (2d) 286; 28 C. J. 620.

[3] See reference in footnote [2] above.

are immaterial to the determination of the essential factor, that is, whether the gift was with or without consideration.

This Court and other Federal courts have held in innumerable cases that transfers of property or payments of money without consideration are gifts and not taxable income. This has been applied to bonuses paid by stockholders to officers of corporations[4], to a railroad company to enable it to construct a railroad[5], and in many other cases where municipalities or private individuals have given money or property to railroads or utilities or other companies in order for them to construct spur tracks or transmission lines or to locate factories in or near a municipality[6]. In analogous situations, where a parent corporation makes a loan to a subsidiary corporation, when on account of the financial condition of the subsidiary there is no expectancy that the loan will be repaid, the advance is classed as a gift and the parent corporation is not allowed to deduct the amount thereof as a loss or bad debt. *American Cigar Co. v. Com.*, 66 F. (2d) 425; *W. H. Young, Inc. v. Com.* (First Circuit Court of Appeals, decided May 23, 1941, not yet officially reported), in which latter case the Court said:

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[4]*Bogardus v. Com.*, 302 U. S. 34; *Blair v. Rosseter*, 33 F. (2d) 286.

[5]*Edwards v. Cuba Railroad Co.*, 268 U. S. 628.

[6]*Great Northern Railway Co. v. Com.*, 40 F. (2d) 372, affirming 8 B. T. A. 225; *Midland Valley Railroad Co. v. Com.*, 57 F. (2d) 1042, affirming 19 B. T. A. 423; *Tampa Electric Co. v. Com.*, 12 B. T. A. 1002; *Aransas Compress Co. v. Com.*, 8 B. T. A. 155.

> "Such advances, made with the belief that they would not be repaid, are in the nature of gifts, and are not deductible as bad debts. American Cigar Co. v. Commissioner, 66 F. (2d) 425, 427 (C. C. A. 2nd, 1933) (3 U. S. T. C., Par. 1145), cert. denied, 290 U. S. 699 (1933); C. B. Hayes, 17 B. T. A. 86 (1929) (C. C. H. Dec. 5365); see Shiman v. Commissioner, 60 F. (2d) 65, 66 (C. C. A. 2nd, 1932) (3 U. S. T. C., Par. 976); cf. Kinkead v. Commissioner, 71 F. (2d) 522 (C. C. A. 3rd, 1934) (1934 C. C. H., Par. 9333); Redfield v. Eaton, 53 F. (2d) 693, 695 (D. Conn. 1931) (2 U. S. T. C., Par. 820); Robert H. Montgomery, 37 B. T. A. 232, 242 (1938) (C. H. H. Dec. 9936); Roy Nichols, 17 B. T. A. 580 (1929) (C. C. H. Dec. 5443); C. H. White, 15 B. T. A. 1375 (1929) (C. C. H. Dec. 5061); Max Baumann et al., Executors, 8 B. T. A. 107 (1927) (C. C. H. Dec. 2799); see Paul and Mertens, The Law of Federal Income Taxation (1934) Par. 28.04, 28.05, 28.17; Annotation, 99 A. L. R. 566, 569."

In each of those cases the advances were made from business and not philanthropic motives, the parent corporation not desiring to be embarrassed by the failure of its subsidiary, and yet the advances were classed as gifts.

The Treasury Department itself has ruled that, where a partnership cancels a debt owing to it by one of the partners[7], or where depositors of a bank relinquish their deposits to the bank and look only to repayment later from stockholders of the bank[8], the transactions were gifts and neither the partner nor the bank received taxable income. In *Rice, Barton &*

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[7] I. T. 1982, Cumulative Bulletin III-1, p. 109.

[8] I. T. 2745, Cumulative Bulletin XII-2, p. 37.

Fales, Inc., v. Commissioner[9], the taxpayer suffered a heavy loss in the manufacture of machinery under a contract. After delivery of the machinery the buyer voluntarily paid the manufacturing company $20,000 so that it could recoup part of its loss. The Commissioner and Board of Tax Appeals held that this was additional income, but the Circuit Court of Appeals held that it was not, as it did not fall within the definition of income laid down by this Court. In discussing the decisions of this Court[10], it said:

> "Not all receipts are income within the meaning of the Act. * * *
>
> "Here there was clearly no legal obligation on the part of Riordan Company to make good the loss suffered by the petitioner. All the petitioner was legally entitled to as gain from its capital invested and labor or both, or from the sale of any capital assets under the contract, it had already received. The additional sum was clearly a pure gratuity given from a sense of fair play in business, an exhibition both commendable and refreshing to find in these days.
>
> "As the court said in Bowers v. Kerbaugh - Empire Co., supra; 'The mere diminution of loss is not gain, profit, or income'."

The Revenue Act of 1934[11] (the governing Act in this case), and every other Revenue Act has expressly excluded gifts from taxable income. The 1934 Act provided that there should be excluded:

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[9] 41 F. (2d) 339.

[10] *Eisner v. Macomber*, 252 U. S. 189, and *Bowers v. Kerbaugh - Empire Co.*, 271 U. S. 170.

[11] Sec. 22 (b) (3).

> "The value of property acquired by gift, bequest, devise or inheritance (but the income from such property shall be included in gross income)."

Article 22 (a)-14 of the Treasury Regulations[12] dealing with the cancellation of indebtedness does not class this cancellation as income. That article specifically recognized that a cancellation of indebtedness may not result in the realization of income, but was promulgated on the understanding that such cancellation may or may not result in taxable income, depending on the circumstances of each transaction. This case does not fall within the second sentence of the Article, as petitioner performed no services for W. D. H. Co., nor does it fall within the third sentence, as petitioner did not purchase its obligations at less than their face value, nor does it fall within any of the provisions of that article.

In the Regulations under the 1932 Act[13] dealing with the same subject, the Treasury Department specifically provided:

> "If, however, the creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income."

This was a frank statement of the law as it has been under not only the 1932 Revenue Act but all prior and subsequent acts, and the mere omission of that

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[12]Regulations 86, Art. 22 (a)-14, copy set forth in Appendix A hereto.

[13]Regulations 77, Art. 64.

sentence in the Regulations under the 1934 Act can add nothing to income as defined by Congress, nor can the Treasury Department by omitting the above sentence convert gifts into taxable income[14].

In conjunction with the foregoing tests as to taxabe income and taxable gifts, Article 1 of Regulations 79 (which was in effect in 1935 and is still applied by the Commissioner), under the gift tax laws is illuminating:

> "ARTICLE 1. *Imposition of tax.*—The statute imposes no tax upon property, but subjects to tax transfers of property by gift. The tax is not limited in its imposition to *transfers of property without consideration, which in common law are termed gifts,* but extends to sales and exchanges for less than an adequate and full consideration in money or money's worth." (Italics ours.)

The Commissioner recognizes by his own Regulations under the gift tax that "transfers of property *without consideration,* which in common law are termed gifts" are gifts and not taxable income. Certainly, the cancellation in this case cannot be both a gift and taxable income, and since there was no consideration moving from petitioner, it falls within the class of gifts and not income.

No one would contend that it meets the test laid down by Mr. Justice Cordoza[15] as follows:

> "Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital,

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[14] *M. E. Blatt Co. v. U. S.*, 305 U. S. 267, 279.

[15] *U. S. v. Safety Car Heating & Lighting Co.*, 297 U. S. 89, 99.

> not the potency of fruition. *With few exceptions, if any, it is income, as the word is known in the common speech of men.* Lynch v. Hornby, *supra*, p. 34. When it is that, it may be taxed, though it was in the making long before. MacLaughlin v. Alliance Ins. Co., supra, at pp. 249, 250; Taft v. Bowers, 278 U. S. 470; Helvering v. Canfield, supra. Cf. Lucas v. Alexander, 279 U. S. 573, 577, 578; Towne v. Eisner, 245 U. S. 418; Eisner v. Macomber, 252 U. S. 189, 206, 207. If exceptions are to be allowed in exceptional conditions, they are inapplicable here."

In the common speech as spoken by the four parties interested in W. D. H. Co., they never thought that by cancelling this indebtedness they would thereby cause their company, petitioner, which had had such a disastrous financial history, to become thereby so heavily indebted to the United States government.

The authorities referred to by the Board and the Circuit Court of Appeals do not in any way sustain their conclusions. *The Madison Railways Company*[16] and *The Springfield Industrial Building*[17] cases were similar to the *Kirby Lumber Company* case, *supra,* where the taxpayer actively bought in its obligations at a discount. In the *L. D. Coddon & Bros., Inc.*[18], and *Lakeland Grocery Company*[19] cases, the debtors actively negotiated with their creditors for a reduction in their indebtedness in order that they might con-

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[16] 36 B. T. A. 1106, 1108.

[17] 38 B. T. A. 1445.

[18] 37 B. T. A. 393.

[19] 36 B. T. A. 289.

tinue in business and in consideration of their attempting to work out the remainder of their obligations. Here the gain to the debtor would fall within the class of income at least resulting from labor or from labor and capital, but none of these were cases where the creditor voluntarily made the cancellation gratuitously. In this connection a recent decision of the Ninth Circuit Court of Appeals[20] is interesting. Two brothers owned a California corporation, the principal business of which was the sale of the "Star Brand" olive oil, which they bought from an Italian corporation that produced this brand of olive oil and that was owned by two other brothers of the same family. The Italian corporation having become wholly insolvent, the California corporation, in order to help the Italian corporation continue in business and be in a position to supply them "Star Brand" olive oil, voluntarily paid a large sum to the creditors of the Italian corporation in satisfaction of its debts. When the California corporation sought to deduct this payment as an expense, the Circuit Court of Appeals in denying the deduction pointed out that it was wholly voluntary on the part of the California company even though the payment might have been expedient and wise from a business standpoint, stressing the voluntary nature of the payment:

> "It has been held by this Court that money voluntarily paid in settlement of the obligation of a third person cannot be said to be a loss to

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[20] *A. Giurlani & Bro. v. Com.*, decided May 15, 1941, not yet officially reported.

the taxpayer within the meaning of the statute."

The action of W. D. H. Co., even if actuated purely by business motives, was in the same category as the payment by the California corporation. W. D. H. Co. did not deduct the amount of the cancelled indebtedness either as an expense or as a bad debt, but its cancellation was a voluntary act on its part to the same extent as that of the payment by the California corporation.

The authorities referred to by the Circuit Court of Appeals likewise are not persuasive. *The American Chicle Co.*[21] case was similar to the *Kirby Lumber Company* case, that is, the Company bought in its obligations at a discount. In *United States v. Little War Creek Coal Co.*[22] the debtor had carried on active negotiations for the cancellation of its indebtedness. In *Burnett v. Sanford & Brooks Company*[23] this Court merely held that, where a taxpayer had a contract to do certain work in 1915 and 1916 in which years it had large expenses but no income and recovered in 1920 a large amount from the United States for breach of the contract, it must report the 1920 recovery as income in that year and not refer it back to 1915 and 1916 because, as this Court said, income taxes are practical matters and taxes must be placed upon an annual basis. In *Maryland Casualty Company v. U. S.*[24] the insurance company had set

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[21] *Helvering v. American Chicle Co.*, 291 U. S. 426.
[22] 104 F. (2d) 483.
[23] 282 U. S. 359.
[24] 251 U. S. 342.

up a reserve in one year for certain contingent liabilities and was allowed under Treasury Regulations to deduct the reserve as an expense. Later business conditions showed the reserve to be excessive and during a subsequent year the insurance company transferred part of the reserve to its free assets. The Court held that the company must take into account as income the amount taken out of the reserve.

There is a line of similar cases where liabilities are taken into account as expenses in one year but are never actually paid and it is held that, when they are taken back into profit and loss, they are to be considered as income during the latter year[25]. However, in all those cases, the gain by the debtor through the wiping out of the liabilities came as a result of the operation of law in barring the collection thereof by statutes of limitation and not, as in the case of a gift, by the voluntary and gratuitous forbearance by the creditor to collect the liability. The courts have held that, as a practical matter, since the taxpayer has received the benefit in one year for income tax purposes of these items as an expense, then, when he in later years is by operation of the law freed from those liabilities, he should then take them into account as income. Cf. *J. T. Sneed, Jr. v. Commissioner*[26], in which the Court held that, where a lessor in an oil and gas lease had taken percentage depletion on a bonus

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[25]For example, *Chicago, Rock Island and Pacific R. R. Co. v. Com.*, 47 F. (2d) 990, and *Charleston & W. C. Ry. Co. v. Burnet*, 50 F. (2d) 342.

[26]Decided by the Fifth Circuit Court of Appeals on May 5, 1941, and not yet officially reported.

received for executing the lease, he must take back into account as income the amount of the depletion deduction in the year in which the lease expired where there had been no production at all. The Court placed its decision simply on the practical ground that where he had had the deduction originally and had never actually lost any capital through the production of oil, he should take it back into account as income when it became apparent that he would have no such capital loss.

We respectfully submit that, whatever the motives of W. D. H. Co. were in cancelling the indebtedness, whether philanthropic or purely business, the cancellation was wholly gratuitous and with no consideration moving from petitioner and was not taxable income.

Conclusion.

It is respectfully submitted that this case is such as to call for the exercise by this Court of its supervisory powers, and we, therefore, respectfully pray that the petition for writ of *certiorari* to the United States Circuit Court of Appeals for the Fifth Circuit be granted.

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